

Central Europe Economics View

Deep recession likely in 2020

- In this report we update our forecasts, taking into account the unprecedented extent of social distancing measures in Poland as well as available data on economic activity in Europe.
- We expect Polish economy to contract by more than 3% in 2020, with biggest hit likely in 2Q, followed by a gradual recovery. Consumption could fall by ~10% QoQ in 2Q.
- In the coming months the number of new unemployed persons will likely rise sharply as firms facing liquidity problems and a drop in demand will try to reduce costs. Unemployment could double, exceeding 10% in the coming months.
- Although the MPC did not signal more rate cuts, we expect the incoming data will change this stance and therefore the base rate will be reduced by additional 50bps to 0.5% in 2Q.
- Taking into account the government's fiscal package (so called *Anti-crisis shield*), the shortfall in tax revenues resulting from recession and the likely deterioration in tax collection, we estimate the fiscal deficit in Poland could reach 7.5% of GDP in 2020.

Piotr Kalisz, CFA

+48-22-692-9633

piotr.kalisz@citi.com

Cezary Chrapek

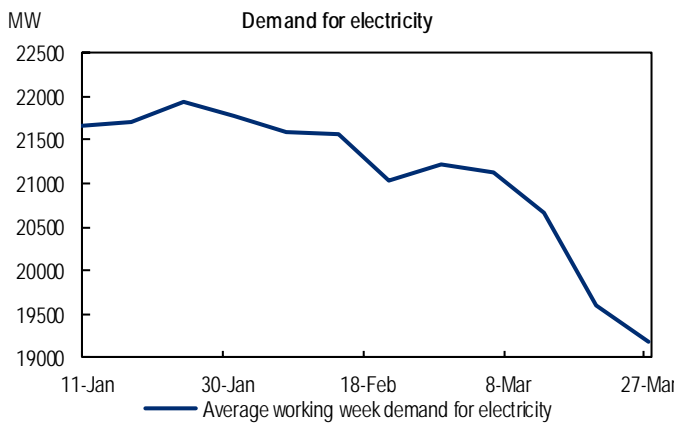
+48-22-692-9421

cezary.chrapek@citi.com

A deep recession likely in 2020

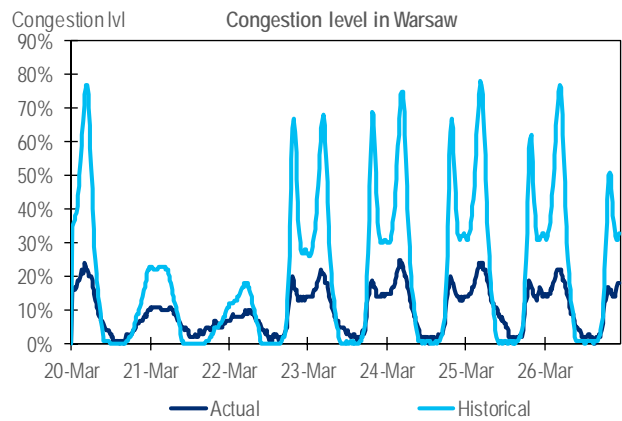
Over last several weeks Poland, along with other Central European countries, introduced a range of social distancing measures. These decisions are likely to have negative impact on economic activity in 1Q and more significantly in 2Q. Already now high frequency indicators, including electricity consumption, trackers of city traffic or motorway traffic are signaling that activity collapsed in the second half of March. By any account the service sector is likely to be hit the most. Although the GUS confidence survey for the services sector was conducted before March 10th and therefore it does not include yet the impact of COVID-19 on activity, the euro area service PMI indices give a flavor of the scale of the shock that may hit Polish service firms.

Figure 1. Electricity consumption in Poland has seen a sharp decline in March (9.3% drop in the last week of March vs. first week of March)



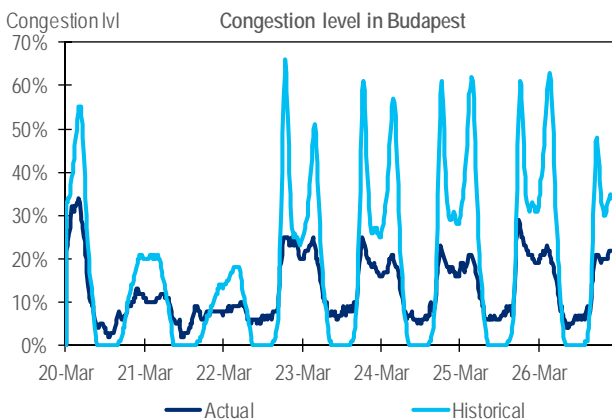
Source: PSE, Citi Handlowy Research

Figure 2. Traffic congestion in Warsaw



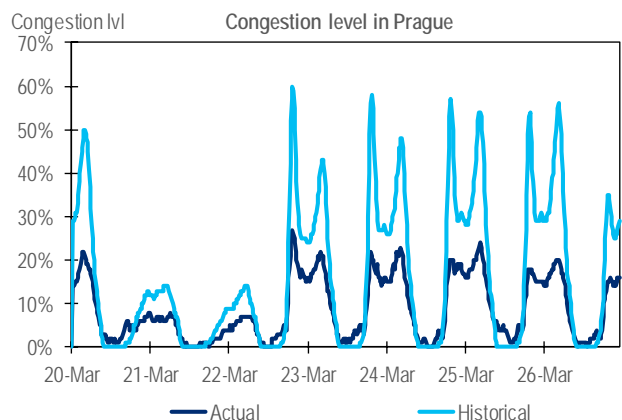
Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

Figure 3. Traffic congestion in Budapest



Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

Figure 4. Traffic congestion in Prague



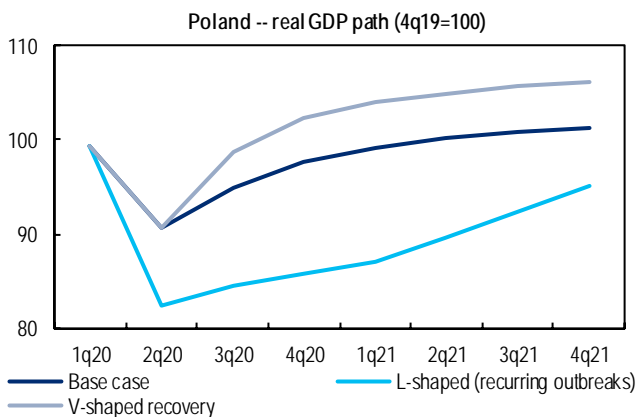
Source: TomTom, Citi Research calculation as of 27 March 2020, 12.55pm

With this in mind we revise our growth forecasts and we now expect the Polish economy to contract by ~3.2% in 2020 versus 4.1% growth in 2019. This would be a significantly worse outcome than during the Global Financial Crisis, when Poland expanded by 2.6%. The key reason is that this time large part of the economy remains in the lockdown and therefore the FX rate, unlike in 2009, cannot work as a stabilizing force. Assuming that the lockdown will remain in place throughout May, our rough estimates suggest that private consumption could fall by ~10% QoQ in 2Q, with risks skewed to the downside. We expect private sector to cut

investment plans sharply, which should be particularly visible in spending on machines and transport equipment. Taking into account the uncertainty regarding future growth outlook we assume ~25% drop in investment in 2Q, though an even deeper contraction appears possible.

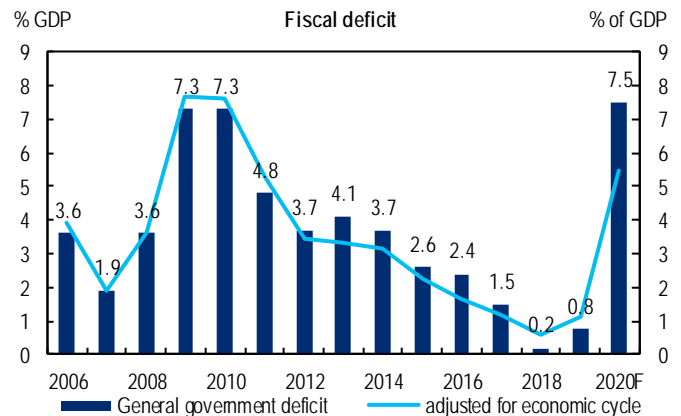
The key question, however, is at what pace the economy can recover in the following quarters. The pace of rebound will depend on whether COVID-19 epidemic will pass in 2H20 or whether it will become a recurring threat, at least until the vaccine is made available. Figure 5 shows potential alternative scenarios. Our base case assumes that lockdowns are gradually removed starting from June and the activity gradually recovers while real GDP returns to 4Q19 levels by mid-2021. The negative scenario is L-shaped and assumes that not only the scale of the 2Q shock is larger, but also the following recovery is substantially slower than in the baseline. As the Figure 5 suggests, we think the balance of risks is asymmetric and potential downward surprises can be potentially bigger than upward surprises.

Figure 5. In the base case we assume real GDP will return to 2019 levels in mid-2021



Source: Citi Handlowy Research estimates

Figure 6. Taking into account the depth of recession, we expect general government deficit to reach ~7.5% of GDP in 2020



Source: Eurostat, Citi Handlowy Research estimates

The labour market will be heavily affected by the recession. In the coming months the number of new unemployed persons will likely rise sharply as firms facing liquidity problems and a drop in demand will try to reduce costs. The extent of layoffs will depend on the length of lockdown but also on the extent of fiscal support for the corporate sector. According to a survey by business organization Lewiatan 69% of Polish firms are planning to reduce employment over next two months and 54% are planning to cut staff by 20-50%. The situation is worse among small sized companies which suggests that the impact on overall employment level may be somewhat smaller than those declarations suggest but it will still be significant. Our base case assumes that the number of registered unemployed will rise on average by ~200 thousand persons per month in May-July period and by the end of the year the cumulative increase will reach 950 thous. (increase vs. December 2019). In the baseline scenario the end-of-year registered unemployment rate is likely to reach 10.9%, thus doubling from the December 2019 level.

The severity of economic shock highlights the need for a large and decisive economic policy stimulus. On March 18th the government revealed a 6% of GDP fiscal package, roughly half of which consists of guarantees. We think this package will probably be increased in the

coming months in response to the deterioration in economic activity (a possibility of changes was indeed signaled by authors of the fiscal package). Yet it is important to emphasize that the fiscal response is unlikely to stop the sharp contraction in GDP in 2Q as the recession will be due to the lockdown and social distancing measures. Higher fiscal envelope will not change anything in this respect. Instead, the size and the structure of the fiscal package as well as the speed at which it is going to be delivered will influence chances of companies to survive the extremely weak 2Q and their ability to return to economic life after the restrictions are removed. Taking into account our new GDP forecasts, the shortfall in revenues due to the recession¹ and the likely substantial deterioration in tax collection, we estimate the fiscal deficit may reach ~7.5-8% of GDP in 2020 while public debt could exceed 50% of GDP. If the fiscal package is upgraded the impact on deficit could be even bigger. This also means that our previous estimates of gross borrowing requirement (GBR) rising by as much PLN 110 bn (4.8% of GDP) to PLN 250bn may be too conservative.

We expect also that the central bank will continue to ease monetary policy. Although at this stage there seems to be no agreement within the MPC regarding further rate cuts, we think the incoming weak data will convince MPC members that additional monetary stimulus is necessary. Having said that we think the base rate will be reduced by additional 50bps to 0.5% in 2Q. The central bank will probably continue to organize regular repo operations and will continue asset purchases. The aim of those steps will not be to boost spending (after all, this would not work during lockdowns) but rather to ensure proper functioning of the market and creating space for the fiscal stimulus announced by the government. As far as the FX depreciation is concerned so far the NBP has been silent, sending no signals of possible interventions. However, in the past the willingness of the central bank to step into the FX market depended on the pace of depreciation rather than on the level of EUR/PLN. Therefore if the PLN move accelerates the NBP could use some of its EUR 116bn of reserves to limit currency volatility and possibly slow the depreciation.

Figure 7. Poland – selected macroeconomic forecasts.

	2019	2020F	2021F
GDP growth	4.1	-3.2	4.7
Private consumption	3.9	-4.1	5.4
Fixed investment	6.9	-15.3	5.4
CPI (eop)	3.4	2.4	2.3
NBP reference rate (eop)	1.5	0.5	0.5
General government deficit (% of GDP)	0.8	7.5	5.2
Public debt (% of GDP)	44.3	52.1	53.0

Source: Citi Handlowy research, GUS, NBP, Eurostat

¹ Assuming 40% sensitivity of the budget to cyclical developments.

Economics Research

Piotr Kalisz, CFA

Chief Economist

+48 (22) 692-9633

piotr.kalisz@citi.com

Cezary Chrapek, CFA

Economist

+48 (22) 692-9421

cezary.chrapek@citi.com

Citi Handlowy

Senatorska 16

00-923 Warszawa

Polska

Fax: +48 22-657-76-80

This document has only been prepared by Bank Handlowy w Warszawie S.A. for information purposes and is not an inducement to enter into any transaction involving any financial instruments. This document is not an investment or financial analysis or any other general recommendation concerning transactions in financial instruments referred to in Article 69(4).6 of the Act of 29 July 2005 on trade in financial instruments.. This document doesn't constitute „information recommending or suggesting an investment strategy” nor an „investment recommendation” as defined in European Parliament Regulation and the Council of EU No 596/2014 on market abuse (April 16th 2014). This material is not an investment research or a marketing communication within the meaning of article 36 of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

All presented information is based on sources commonly regarded as reliable. The Bank has made every effort to prepare the presented document with the reliability, completeness and due diligence, however, Bank will not assume any responsibility for the accuracy and completeness of any information in this document, including when the underlying information on which the report was prepared was not complete. Any terms and conditions presented in this document are only for discussion and may change. All opinions and forecasts contained in this document constitute an assessment for the date of publication and may be subject to change without notice.

It is exclusively Client responsibility to make the final decision whether or not to enter into a transaction and for the final result of investment decision taken based on information contained in this material. The Bank can conclude reverse hedging transactions to transactions entered by the Client, that may, but don't need to have, a negative effect on the market price of a financial instrument, interest rate, index or other market parameter underlying the transactions. The information contained in this publication which refers to past listings or performance of investments in a given instrument, financial index or indicator does not constitute a guarantee that the listings or performance of investments in the same instrument, index or indicator will follow the same or even a comparable trend in the future. Any presented forecasts are based on specific assumptions, analyses and models used by Bank, therefore, actual quotations and the results of investment in the presented instruments, indices or financial indicators may significantly differ from the projected value.

The Bank or any other subsidiary of Citigroup Inc. may occur to be an issuer or creator for identical or similar to those described in this document financial instruments. Bank (or other entity of the Group of Citi or its directors, specialists and other employees) may be involved in both buying and selling instruments described herein. The Bank does not act as an advisor or a broker in financial instruments described in this market comments. The Bank certifies that the information contained in the presented document accurately reflect his own opinions and that it has not received any remuneration from issuers or creators of instruments, either directly or indirectly, for such opinions. The Bank has in place appropriate procedures and solutions to manage properly conflicts of interest.

The Bank has not developed this market commentary based on the individual situation of the customer and not evaluated its adequacy for a Client with regard to any financial instrument described in this market comments, even if the Bank was in a possession of information as to the adequacy of certain financial instruments, investment strategy, etc. The Bank reserves the right to discontinue the distribution of market comments to selected or all customers.

Copying and distributing this document, in part or in whole, is only authorized upon the prior written consent of the Bank, except where the disclosure of this document is mandatory in legal or administrative proceedings. The activities of the Bank are supervised by the Polish Financial Supervision Authority (Komisja Nadzoru Finansowego). This document has been prepared for information purposes only and does not constitute a sale offer within the meaning of Article 66 of the Polish Civil Code and imposes no obligation to enter into any transaction. Citi and Citi Handlowy are registered trademarks of Citigroup Inc., used under license. Citigroup Inc. and its subsidiaries have also the rights to certain other trademarks used in this document.

Bank Handlowy w Warszawie with its registered office in Warsaw at ul. Senatorska 16, 00-923 Warszawa, entered in the Register of Entrepreneurs of the National Court Register by the District Court for the capital city of Warsaw in Warsaw, 12th Commercial Department of the National Court Register, under KRS No. 000 000 1538, NIP 526-030-02-91; the share capital is PLN 522,638,400, fully paid-up.